Modification of "Use-or-Lose" Rule for Health Flexible Spending Accounts

Issue Date: November 2013

The IRS has issued Notice 2013-71 which modified the §125 Health Flexible Spending Account (HFSA) 'use-or-lose' rule to permit up to $500 of unused HFSA account balance to be carried over to the following plan year. HFSAs can offer the current 2½ month grace period, or the new $500 carryover option, but not both. The carryover amount also does not count against the $2,500 salary reduction limit applicable to HFSAs.

Background

§125 rules prohibit participants from using contributions made to a HFSA for one plan year to provide a benefit in a subsequent plan year (commonly called the "use-or-lose" rule), and any unused contributions remaining as of the end of the plan year are forfeited.

§125 rules were subsequently altered to allow for a grace period for HFSAs, during which participants are permitted to use contribution amounts remaining from the previous year to pay expenses incurred for benefits during the period of up to two and a half months immediately following the end of the plan year.

Changes to HFSA Carryover Rules

Under these new IRS rules plan sponsors are allowed to amend their plans to permit participants to carryover up to $500 of unused HFSA funds into the next plan year. The amount remaining as of the end of the plan year (after any applicable run-out period) may be used to reimburse eligible expenses incurred during the entire plan year to which it is carried over.

- Employers are not required to allow the optional $500 carryover, and could permit a lower carryover amount. If a plan chooses to allow for this carryover, the same carryover limit must apply to all plan participants.
- Any unused amount in a plan year (after any applicable run-out period) that exceeds $500 must be forfeited.
- Any unused amount remaining in an employee's HFSA as of termination of employment must be forfeited (unless, if applicable, the employee elects COBRA continuation with respect to the HFSA).
- The carryover does not affect a participant's ability to elect up to $2500 in pre-tax salary reductions for future plan years.
- Plan must choose between the 2½ month grace period allowed under current rules, or the $500 carryover option. A plan may not offer both.
- The carryover amount is not "cumulative" from year to year. In other words, a maximum of $500 may be carried over from one plan year to the next, even in a case where the participant has not used funds carrier over from previous plan years.

Administration Considerations

Adoption of the carryover creates a number of administrative issues that must be addressed. Many employers use a TPA to administer their HFSA so the plan sponsor may need to coordinate these issues with their vendor.

- Plan documents must be amended, including the elimination of exiting grace periods (see more below).
- The carryover amount available to an individual will not be known until the end of any applicable claim submission "run-out" period. This could make administering reimbursements during the run-out period complicated. To address this, the rules allow administrators to use current plan year funds first before using carryover amounts. If a participant were to submit claims for more that their current year election early in the plan year the administrator would have to limit the reimbursement to current year amounts until the total carryover amount is determined at the end of the run-out period.

Impact on HSAs
Individuals are ineligible for HSA contributions if they are covered by a "full" HFSA which reimburses eligible expenses prior to the individual meeting specific HSA deductible amounts. A participant who carries over HFSA amounts to a new plan year would make that individual ineligible for HSA contributions in the carryover year, even if they do not contribute anything to the HFSA in the new year. In this case the individual would not be able to contribute to an HSA until after all HFSA funds are "spent down". Employers could address this problem by designing an HSFA plan that automatically converts to a limited purpose HFSA for participants who have only roll over funds available, and who do not make a new HFSA election in the carry over plan year.

Cafeteria Plan Written Amendments
If the plan chooses to implement this new carryover rule, the §125 cafeteria plan documents must be amended accordingly (including eliminating the grace period provision, if applicable).

For plans beginning 1/1/2014 the amendment must be adopted on or before the last day of the plan year from which amounts may be carried over. The amendment may be effective retroactively to the first day of that plan year as long as participants are informed of the carryover provision.

- For example, sponsors who wish to implement the carryover provision for a plan that begins 1/1/2014 will need to amend the plan no later than 12/31/2014

Special rule for plan years beginning in 2013
A plan with a plan year that began in 2013 may be amended to adopt the carryover provision no later than the last day of the 2014 plan year. However, this special rule does not apply to plans with a grace period.

- A plan with a grace period must be amended no later than the end of the plan year from which amounts may be carried over. Consequently, a plan with a grace period and a 1/1/2013 – 12/31/2013 plan year would need to be amended no later than 12/31/2013.

The plans ability to retroactively eliminate a grace period provision previously adopted for the plan year may be restricted by other non-Code (e.g. ERISA, etc.) rules. Consequently any plan sponsor considering retroactive plan amendments which eliminate an existing grace period should seek the advice of a qualified advisor.

Summary
The addition of a carryover option to a HFSA obviously may increase participation and reduce employee forfeitures. At the same time the implementation of this provision will require some additional administration, and significant employee communication, on the part of the plan sponsor.

The IRS has published a fact sheet on the changes available at: http://www.treasury.gov/press-center/press-releases/Documents/103113FSA%20Fact%20Sheet.pdf.

Notice 2013-17 also contains a number of examples of how the carryover will work. Notice 2013-71 can be found at: www.irs.gov/pub/irs-drop/n-13-71.pdf.